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TAGS: PREL PGOV PINR ECON EAID EFIN ET ER
SUBJECT: ERITREA'S ECONOMY ON THE ROPES; DOES THE GSE HAVE THE WILL TO SAVE IT?

CLASSIFIED BY: AMB Scott H. DeLisi, for reasons 1.4 (b) and (d).

¶1. (C) Summary: With telephone outages the norm, electricity essentially rationed, and imports cut to next to nil, Eritrea faces an economic crisis. Since the end of the war with Ethiopia in 2000, Eritrea has maintained a heightened state of national security. For the Government of Eritrea (GSE) everything, including the country's economic stability and viability, is secondary to ensuring the protection of the nation-or so the government asserts. For the past four years, economic policy has reflected the political policy of "no war, no peace", resulting in high defense spending and continued conscription of a large percentage of the labor market into national service. This focus has left Eritrea with a debt that is unsustainable and an economy crumbling to bits. One possibly positive note to come from this is that at the IMF meeting in March, the Eritrean authorities expressed a willingness to engage more deeply with the Fund, seeking to initiate the process that will lead to HIPC and other debt relief programs. However, whether the GSE has the political will to enact the reforms necessary for IMP and HIPC support is a proposition that many here question. It is also possible that the severe economic problems the country faces could be a further incentive to the GSE to bring the border stalemate to closure but, again, much will depend on the GSE's political will and its own assumptions about how much more hardship the Eritrean people can bear. End Summary.

ERITREA'S ECONOMY: AN OVERVIEW OF THE NUMBERS

¶2. (U) Eritrea is one of the poorest countries in the world, with per-capita income of USD 157 in 2005 and a rank of 161 out of 177 countries in the 2005 UN Human Development Index. Various sources estimate that the 2005 real GDP for Eritrea is approximately 770 million USD. (Note: Changes to the exchange rate in 2005 from 19.5 to 15 Nakfa to the USD affect the conversion on nominal GDP leading to an overstated GDP estimate. End Note.) GDP growth is estimated at 4.8 percent, up from 2004 yet due mostly to the government appreciation of the Nakfa and the strangling of imports. In the 2005 Article IV consultations, the IMF estimated the net present value of

the total government debt at 164 percent of the GDP, with domestic debt representing 111 percent and external debt 53 percent of the total.

¶3. (C) Inflation is eating away at any small growth in GDP. The head of the PFDJ-owned Housing and Commerce Bank, Berhane Tekeste, recently told PolOff that inflation was running over 20 percent. The World Bank reports pegged the CPI at 21.5 percent for 2004, significantly above the sub-Saharan average, yet the 2005 IMF estimates the CPI for 2005 is 12.4 percent. Locals report significant increases in local prices, commenting that one year ago a candle was 50 cents Nakfa and now it is five Nakfa, if you can even find one in the store. Moreover, the prices of general food stuffs are becoming prohibitive for the average Eritrean. A sixty Nakfa (USD 4) loaf of bread, petrol at roughly Nakfa 120 (USD 8) a gallon, and coffee at 50 Nakfa (USD 3.30) per pound instead of the pre-war price of 17 Nakfa make life almost too costly to live for many here.

TRADE, WHAT TRADE?

¶4. (U) Eritrea's once burgeoning trade with Ethiopia and Sudan crashed with the end of bilateral relations with both countries. A positive current account balance is a thing of the past; World Bank estimates the 2004 balance was a 45 million USD deficit. Since a high of nearly USD 200 million in 1997, Eritrea's exports of goods and services have declined dramatically to an estimated USD 12 million in ¶2005. Exporting predominantly agricultural items in the past such as livestock and sorghum, Eritrea historically had a small textile industry and a small salt industry as well. Yet, as previously mentioned the termination of trade with Ethiopia and Sudan decimated the export business.

REVENUE? FROM WHERE?

¶5. (C) As exports are minimal, from where does the government revenue come? According to the IMF, total government revenue was USD 370.2 million with 72 percent coming from tax revenue, presumably including an estimated USD 100 million paid by Eritreans living overseas. The remaining come from grants and other non-tax revenues. What fuels the economy according to Mathewos Woldu of the Ministry of National Development, are tourism, agricultural and fishing industries; money from the diaspora (both the official tax and remittances) and borrowing. In reality, it is the diaspora and borrowing that keeps the economy alive today.

SPENDING, SPENDING, SPENDING

¶6. (C) With a growing debt, where does the money go? Debt service is nearly 25 percent of revenues. Estimates for defense spending vary from 17 percent to nearly 50 percent. In a speech given in 2005, President Isaias, stated that half the GSE expenditures are for national security. Without a transparent budget and the understanding that hardware purchases such as tanks and weapons may not be reflected in any published numbers, President Isaias's statement may reflect a reality. The remainder of expenditures are essentially on wages for government employees and on materials. Mathewos told PolOff that the debt burden is the greatest economic challenge faced by the government.

¶7. (U) Of importance is the growing oil bill for the nation. With an estimated USD 108 million spent on petroleum products, increases in the global oil prices will significantly squeeze Eritrea. With gasoline costing USD 8 per gallon and electricity cuts a regular occurrence, the price of oil is a constant issue in Asmara. In the monitoring and assessment of avian flu, the government's delay in allocating funds for gasoline for the Ministry of Agriculture vehicles to travel in response to reports

stalled the initial efforts to respond. As Eritrea has no oil production, much of the imported oil comes from Libya. There are rumors in Asmara that the tab is rapidly growing and has not been paid in some time.

NO WAR, NO PEACE, NO LABOR MARKET

¶8. (U) No one knows the exact number, however an estimated 600,000 Eritreans are believed to currently be in national service, approximately 40 percent serving in the military and the remaining 60 percent working for extremely low wages in government ministries and government-owned enterprises. Many in the second group are demobilized on paper, however, they can be recalled to the military at any time. With the requirement for national service, which could include working in the fields during harvest, construction on infrastructure projects or other hard labor, individuals are not able to participate actively and freely in the labor market. Many have had their education or technical training cut off or limited and, with the University closed and post-secondary education controlled completely by the government, the future viability of the labor market remains in question. In fact, when one considers the national service cadres may constitute between 15-20 percent of the total population and a much higher percentage of the available work force pool over the age of 18, the labor market faces serious strains as does the labor pool for agricultural production. While the GSE may claim success with the World Bank-funded demobilization project, the World Bank Country Director in Eritrea is quick to point out that meeting the technical requirements does not always mean a program is successful. National service seems to have a steady flow of intake, so while national service members may not be doing military service on paper, those who are not are Eritrea's ready reserves.

DEBT SUSTAINABILITY

¶9. (U) With regards to the debt, heavy government involvement in the economy and the artificially low setting of treasury bill interest rates has kept the domestic portion of the debt low. Basically, the GSE is able to delay repayment of these domestic loans, most taken out during the conflict with Ethiopia. Furthermore, GSE has been able to fob off members of the Diaspora holding this debt by offering them land in Eritrea and facilitating the means to construct new houses in the homeland. As for the external debt, grace periods began expiring within the last few months, and the pressures of these will be felt acutely.

¶10. (U) The bottom line is that Eritrea can not continue to sustain the debt. At the IMF Executive Board Meeting, Eritrea announced its interest in engaging in a fund-sponsored program that would lead to debt relief initiatives. Cutting it close to the 2006 deadlines, Eritrea will need to move swiftly if it is truly serious about its commitment to the program and process. Yet, when pressed about what the complications might be for Eritrea, the Ministry for National Development's Mathewos was loathe to give a specific answer. The concern among many observers is that the requirements for transparency, demobilization and reducing defense spending may prove too much for the GSE to swallow.

COMMENT

¶11. (C) In a striking departure from earlier positions, the GSE now claims to be ready to engage international partners seriously on the economic reforms that can lead to HIPC qualification. However, even with the GSE's stated interest in the debt relief program, they may hold these programs hostage to border demarcation - or may feel themselves unable to consider reforms absent resolution of the border issue. With demobilization and defense spending

reduction among the IMF list of concerns, the GSE may balk as long as they feel the national security of Eritrea is at risk. The border and economic reform are inextricably linked for the GSE. Progress on either, or both, will come down to whether the GSE has the political will and commitment to make progress a possibility. In the past, the Eritrean leadership has shown a willingness to allow its ideological vision of "one nation, one party, one people," to trump pragmatism on economic decision-making. Given that history, it is not a stretch to think that the GSE may be willing to let Eritreans tighten their belts and suffer a while longer before agreeing to fundamental changes in economic policy or philosophy. End Comment.

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